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Public Service Commission of Wisconsin
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BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Application of Milwaukee Water Works, Milwaukee County,
For Authority to Increase Water Rates — Docket No. 3720-WR-107

SUPPLEMENTAL REBUTTAL TESTIMONY OF ERIC ROTHSTEIN
July 19, 2010

Q. Please state your name.

A. My name is Eric Paul Rothstein.

Q. Did you provide testimony on behalf of the intervening wholesale customers related to Milwaukee Water Works' (MWW) initial rate application and the cost of service study (COSS) prepared by Public Service Commission staff?

A. Yes.

Q. Have the intervening wholesale customers authorized you to provide testimony on their behalf regarding the revised MWW rate application and revised cost of service study (COSS) prepared by Public Service Commission staff?

A. Yes.

Q. Have you reviewed the supplemental direct testimony and exhibits submitted in this case, including the revised cost of service study (COSS) prepared by Public Service Commission staff?

A. Yes.

Q. What is the purpose of your testimony?

A. I will address the supplemental direct testimony of Kathleen Butzlaff, Lois Hubert, Andrew Behm, and David Prochaska, as well as the revised MWW rate application.

Q. Please discuss your comments on the supplemental direct testimony of Kathleen Butzlaff and Lois Hubert.

A. Ms. Butzlaff's testimony presents her revised revenue requirement proposal for Milwaukee Water Works (MWW) based on MWW's revised rate application submitted on June 1, 2010 (PSC REF#: 132459), and June 10, 2010, (PSC REF#: 132927). This revenue requirement preserves, without adjustment, MWW's requested rate of return for retail service of 5.00% and 6.50%. Ms. Butzlaff notes: "This results in a composite return on net investment rate base of 5.18 percent. A return on rate base of 5.18 percent will provide a 5.27 percent return on municipal earning equity and adequate times interest coverage." (SD 12.2, lines 16-19) Ms. Hubert's testimony further explains, "…the return on net investment rate base (NIRB) is based on the cost of 30-year municipal debt plus 2 percent. This methodology is capital structure neutral." (SD 12.6, Lines 14-16)

Perhaps the most remarkable aspect of this testimony, especially in the context of a proposed 26% system average rate increase, is that there is effectively no explanation of why these attributes of the methodology are appropriate and protective of the public interest. In 2007, MWW's requested and approved rate of return was 3.30%. This return represented just under $9 million of the roughly $70 million MWW revenue requirement (12.86%). Ms. Hubert cites this case in her testimony, highlighting the Commission's May 31, 2007 Final Decision in docket 3720-WR-106 which noted:

> *"The return requested by the applicant on rate base of 3.30 percent would provide a return on municipal equity which is below the current cost of municipal capital.* The applicant desires to mitigate the rate increase on present water customers and believes that such return will generate sufficient monies to meet its needs in the test year." (SD 12.11, Lines 14-19)

Ms. Hubert goes on to note, "One reason that MWW was able to mitigate its rate increase in 2007, by accepting a lower NIRB, was because its high equity levels still provided sufficient debt coverage." (SD12.11, Lines 20-21)

Ironically, in 2010, in the context of one of the worst national economic recessions in U.S. history, the apparent desire of both MWW and PSC to mitigate the rate increases on present water customers has evaporated. Irrespective of whether or not the PSC's capital structure neutral approach to determination of rate of return is appropriate, there certainly is precedent for deviation when it serves the public interest. Even if some increase in MWW's allowed rate of return is appropriate, it is hard to understand how an increase in return that results in a single year rate adjustment in excess of 25% serves the public interest.

Yet, while Ms. Hubert asserts that the PSC's approach is "capital structure neutral," it seems noteworthy that she acknowledges that MWW's high equity levels helped enable it to reduce rate increases and still provide "sufficient" debt coverage. In fact, given MWW's atypical capital structure, the sufficiency of debt coverage is never in doubt. MWW's requested and PSC affirmed, rate of return of 5.18%, will result in net revenues available for debt service of over $37.8 million where MWW's revenue bond debt service is scheduled to be $1.2 million (Exhibit 2.59, p. 26), which will result in a debt service coverage ratio in excess of 32 times, as compared to a covenant requirement of 1.1 times. Even incorporating MWW's General Obligation bonded indebtedness, net revenues available for debt service resulting from MWW's requested rate of return will result in debt service coverage in excess of 11 times.

Q. **Would the MWW requested, and PSC affirmed, rate of return result in an unreasonable amount of money being made available to the City of Milwaukee?**

A. Yes. The fundamental danger of myopically applying the Commission's standard methodology without regard to either capital structure or the fact that MWW is a municipal rather than private shareholder owned utility is that the resultant rate increases well exceed what is required to sustain MWW, and generated returns will well exceed what should be made available to the City of Milwaukee. Application of a utility basis approach to government-owned utility ratemaking should not be employed without any consideration of cash flows. Indeed, the AWWA Water Rates manual of practice states that *"[i]n any particular government-owned utility, the magnitude of existing debt service and the policy regarding the amount of revenue financing of capital improvements will influence the required level of return*." (AWWA M1, Principle of Water Rates, Fees and Charges, p.10-11) In this instance, it is important to recognize that of the $15.3 million of return to be generated from an allowed 5.18% rate of return, debt service obligations claim approximately $4.4 million, resulting in over $10 million of return accruing to MWW.

Ms. Hubert, addressing concerns related to intergenerational inequities arising from MWW's relative absence of debt, states that *"[t]he utility may use its net income to finance capital investments or may distribute the net income to its stockholders (in this case, the city of Milwaukee)."* (SD.12.7, Line 23 and SD.12.8, Line 1). When considered in combination with the fact that the City of Milwaukee is the recipient of a payment in lieu of taxes of $9.5 million (Exhibit 2.60), the PSC's approved rate of return will result in approximately $20 million of the $87 million MWW revenue requirement being for funds subject to the City of Milwaukee's discretion. While the City of Milwaukee is certainly entitled to a return for its ownership of the MWW system and payments in lieu of taxes, it is not reasonable for nearly 23% of MWW revenue requirements to be comprised of amounts that the City of Milwaukee may claim.

Q. **Doesn't your objection result from focusing on cash-basis considerations when the State of Wisconsin employs a utility-basis approach for determination of revenue requirements?**

A. No. I am simply referencing some of the cash-flow implications of the PSC's potential approval of a 5.18% rate of return to place into context how rigid adherence to the PSC's prescribed rate of return methodology may produce unreasonable, inappropriate outcomes. Utility rate-making involves more than completion of predefined calculations. The very reason for PSC regulation is to ensure the public interest is served by insightful application of the principles of rate-making. This is particularly so in this case where the utility's capital structure is atypical and where public ownership affects the risks and costs of capital faced by MWW.

Q. Why should capital structure be considered in the Commission's application of the utility-basis approach in the case of MWW?

A. While the Commission's "capital structure neutral" approach may be more reasonable for utilities that have relatively typical capital structures, it is important to recognize that MWW's capital structure is quite atypical – not only for other utilities in Wisconsin (as illustrated in my initial rebuttal testimony, Exhibit 2.19), but also relative to other major metropolitan water utilities in the United States. As shown in Exhibit 2.61, MWW's debt/equity ratio is at the very extreme end of the spectrum of surveyed water utilities with treatment capacity exceeding 70 MGD.

As noted in my initial rebuttal testimony (R 2.35, Lines 16-20), AWWA's (M1) manual states: "*Sometimes the actual capital structure of a water utility may have excessive amounts of debt or equity. In such cases, an alternative capital structure is used to determine a fair rate of return. ...Regulatory agencies have imputed a hypothetical capital structure* *based on an examination of similar companies or industries.*" (p.41). Importantly, industry standard practice calls for recognition of atypical capital structures and deviation from typical return calculations when atypical capital structures exist. This is required to determine a "fair" rate of return – one that serves the public interest.

Q. Does Ms. Hubert's supplemental testimony address your concerns regarding MWW's atypical capital structure?

A. No. Ms. Hubert reminds that the Commission's rate of return methodology is "capital structure neutral" – explaining at considerable length that the rate of return would not differ under different capital structures because the Commission prescribed return on net investment rate base (NIRB) is based on the cost of 30-year municipal debt plus 2 percent. This is a fine restatement of the Commission's standard methodology, but offers no justification for <u>why</u> application of this methodology remains appropriate in light of MWW's atypical capital structure and industry guidance noting that an alternative capital structure may be used to determine a fair rate of return where there is an atypical capital structure. In the context of a MWW request that would require rate increases in excess of 25% for a utility with an atypical capital structure, the public interest is clearly not served by reliance on the Commission's standard approach simply because it is standard, and despite the fact that doing so yields an unfair rate of return. Insight is required.

Q. **Do you have any comments in response to Ms. Hubert's supplemental testimony regarding your recommended adjustments to the allowed rate of return and deviation from the Commission's standard approach?**

A. Yes. Ms. Hubert states that: *"[r]educing the weighted return on NIRB would be a disincentive to the city. It would also provide a windfall to the non-property owner customers, who under Commission current methodology are unaffected by the capitalization* *of the water utility."* The existence of this "disincentive" is hard to countenance. Under my proposal, MWW would obtain $7.7 million in return (as well as payments in lieu of taxes of $9.5 million), an amount equivalent to what a utility with a more typical capital structure would obtain if granted MWW's requested rate of return. Moreover, if anything, it is MWW who would be provided a windfall if allegiance to the Commission's standard approach is sustained. My proposed rate of return adjustment is solely designed to adjust MWW's return to mitigate the unfair return that would be obtained without recognizing the implications of MWW's atypical capital structure.

Q. Are there other justifications for a reduction in the allowed rate of return?

A. Yes. In countering my proposal for a rate of return adjustment, Ms Hubert states: *"If MWW did have a 50 percent capital structure, Ms. Butzlaff would have determined that the return on municipal earning equity is 6.04 percent and the weighted return on NIRB would still be 5.18 percent."* (SD 12.11, Lines 1-3) In other words, the allowed return on equity is not a function of the relative risk borne by MWW, but rather may simply be derived using a prescription for allowed return that may be imposed irrespective of capital structure or public ownership considerations. The PSC's acceptance of MWW's requested rate of return without any commentary on whether or not this return is reasonable is disconcerting, especially in light of the exceptionally high resulting rate increases. Again, this seems a consequence of unquestioning reliance on the Commission's standard approach without considering appropriate adjustments to serve the public interest.

Yet, as with issues of capital structure, the allowed rate of return should not be derived by rote calculation but should be considered in the context of relevant risks and MWW's public ownership, as well as the cost of debt. MWW is entitled to the same rate of return as permitted for privately owned utilities per Wis. Stat. § 66.0811(1). Accordingly, as would be the case in a determination of rate of return for a privately owned utility, the permitted rate of return should reflect MWW's relative risks and costs of equity. MWW's risks are relatively limited, and shared proportionately by its wholesale customers who bear the costs of excess capacity and regulatory compliance, perhaps MWW's most profound risks. It has more than adequate system capacity and water supply, a diverse and relatively stable customer base, exceptionally limited debt, and high quality, experienced utility management. Perhaps more notably, as a public entity, MWW does not raise equity capital in the same manner as private utilities. MWW's effective cost of equity may be regarded as the opportunity cost of its using available funds toward reinvestment in the MWW system (as opposed to other potential uses of earned surplus). A market metric of this opportunity cost is the City's cost of debt – what it would have to pay to obtain funds for these alternative purposes. Recognizing the risk and cost structure of public utilities, MWW's rate of return may logically be set at the cost of debt -- 4.32% -- the cost cited in Kathleen Butzlaff's testimony (D12.2, Line 15).

Q. Are other distinctions between municipal and private ownership not fully acknowledged in Ms. Hubert's testimony?

A. Yes. Ms. Hubert offers two statements that are particularly troublesome for MWW ratepayers generally, and outside-City and wholesale customers in particular. In response to Mr. Rau's expressed concerns about MWW's failure to employ debt to finance long-lived water main assets, Ms. Hubert states: *"Any earned surplus (Account 216.1) of the water utility reflects earnings that could have been transferred to the city's general funds and returned to the property owners through lower property taxes.*" (SD12.5, Lines 13-15) Similarly, in response to my expressed concerns about MWW's predominant use of cash financing, Ms Hubert states: *"The utility may use its net income to finance capital* *investments or may distribute the net income to its stockholders (in this case, the city of Milwaukee).*" (SD12.7, Line 23, SD12.8, Line 1). Under this construction, Ms. Hubert would have the City of Milwaukee entitled to be the recipient of the entirety of the approximate $20 million of combined return and PILOT payments included in MWW revenue requirements. Yet, appropriately, MWW does not actually have this discretion. Wisconsin Statutes § 66.0811(2) provides that:

> The income of a municipal public utility shall **first** be used to make payments to meet operation, maintenance, depreciation, interest, and debt service fund requirements, local and school tax equivalents, additions and improvements, and other necessary disbursements or indebtedness. . . . Income in excess of these requirements may be used to purchase and hold interest bearing bonds, issued for the acquisition of the utility; bonds issued by the United States or any municipal corporation of this state; insurance upon the life of an officer or manager of the utility; or may be paid into the general fund. [Emphasis added.]

Under this statute, the City of Milwaukee is not entitled to **any** form of general fund transfer, beyond the payment in lieu of taxes, unless all the other items identified in the statute have been funded. As outlined in my initial rebuttal testimony (R2.28, Line 12-23; R2.29, Lines 1-2), MWW has underinvested in water mains at least since 1997. Where depreciation rates suggest that water mains' useful life averages about 77 years, MWW has been replacing water mains at a pace suggesting a 177 year renewal period. MWW has not first made payments to meet utility related requirements that must be satisfied before payments to the general fund.

Q. Do you have other concerns regarding the supplemental testimony offered by Lois Hubert's testimony?

A. Yes. Ms. Hubert mischaracterized my (and I believe Michael Rau's) testimony related to use of debt in capital financing and intergenerational inequities. Ms. Hubert makes significant distinctions between concerns over impacts to property owners (citing Rau's testimony) versus impacts to ratepayers (my testimony). These distinctions muddy the point. Whether characterized as City property owners or more generally as ratepayers, it is the decision to eschew the strategic use of debt while at the same time requesting major rate increases that is problematic. It is not equitable to require current ratepayers to absorb substantial rate increases, nominally because of financial challenge, when MWW has the ability to raise capital and distribute costs over time.

Moreover, Ms. Hubert is incorrect in her statement that, "*[i]n theory, the only way to eliminate all intergenerational inequality for property owners would be to finance the utility with 100 percent debt. No contributed capital would come from taxpayers and any current income would be transferred to the city and returned to property owners.*" (SD12.5, Lines 22-23; SD 12.6, Lines 1-2) When one recognizes that appropriate asset management of water systems is generally founded upon an annual amount of reinvestment in the system, it is relatively easy to construe an equitable distribution of costs whereby current equity is employed to make annual reinvestments (an effective ongoing annuity payment shared equally across generations) and debt is used to spread costs of "lumpy" system investments. One of the wholesale customers' principal concerns is that MWW has not adequately reinvested in its system – causing higher than necessary maintenance expenses and inviting costly system component failures in the future.

Ms. Hubert also mischaracterized my testimony with respect to Contributions in Aid of Construction (CIAC), inferring that I believe intergenerational inequities arise from the fact that wholesale customers have had to make CIAC payments. I recognize this and, in general, the wholesale customers' concerns – as outlined in Pat Planton's testimony – relate to the absence of recognition of such CIAC contributions for transmission mains in the allocation of transmission and distribution related costs.

Similarly, Ms. Hubert mischaracterized my testimony with regard to my statement that "[w]holesale (and retail) customers have paid for MWW to accumulate so much equity." (R2.32), by indicating I contend that ratepayers pay a "premium because of MWW's equity level." (SD12.10, Lines 1-2) Yet, my point is not that MWW has charged a premium in the past because of its high equity levels, but that MWW's accumulation of equity has occurred over many years through ratepayers' duly made payments. I agree that "*it must be recognized that all of MWW's earning equity is either contributed capital from the city of Milwaukee or earnings it is entitled to earn on the city's contributed equity and earned surplus*." (SD12.10, Lines 6-8) Indeed, wholesale (and retail) rate payments engendered prior years' earned surpluses that precipitated MWW's atypical capital structure. What is fundamentally disagreeable is that now, having built an exceptionally strong equity position, MWW would so dramatically deviate from what served the public interest in 2007. Ms. Hubert's testimony suggests that allowing a lower than requested rate of return would be a disincentive to MWW. As shown above, this disincentive is illusory at best.

Q. What comments do you have regarding the supplemental testimony offered by Andrew Behm?

A. My comments relate to Andrew Behm's testimony related to the Economic Development Rate requested by the City of Milwaukee. Mr. Behm's acknowledgement that MWW's wholesale customers "*should have access to the EDR*" (SD12.25, Lines 5-6) is important and sets the stage for a determination of how, rather than if, an EDR rate should be implemented for the region served by MWW.

Q. How do you believe an EDR rate for wholesale users should be implemented?

A. Mr. Behm suggests that a separate wholesale rate should be implemented in the event that the Commission agrees that wholesale sales should qualify for an incentive rate. While I agree that potential EDR customers would be subject to different rates depending on their retail service provider, a common approach to the extension of an economic development rate should apply across the region.

Q. How would an EDR be administered across the MWW retail and wholesale service areas?

A. In general, once a prospective EDR user is qualified, it would be entitled to the economic development incentive irrespective of whether it was located in a MWW retail or wholesale service area. The economic development incentive would equal a given reduction in unit charges for water usage eligible for the discount. If the qualified EDR user is located in the City of Milwaukee, it would be subject to a reduced retail rate. For illustration's sake, a qualified EDR user may pay \$1.35 per 1,000 gallons, instead of \$1.50 per 1,000 gallons. Similarly, if the qualified EDR user is located within the boundaries of a wholesale community, it would be subject to an equal reduction in unit charges. Under my illustration, the reduction in its rate would be \$.15 per 1,000 gallons subtracted from the applicable retail rate in its community.

The amount the wholesale customer pays to Milwaukee would be reduced by the economic development incentive provided to EDR qualified users in the wholesale community. That is, the wholesale communities would pay Milwaukee their established wholesale rates for usage for all water provided to the wholesale community, less the EDR user's retail consumption within the wholesale users service area multiplied by the EDR incentive.

Because the retail consumption of EDR qualified users is eligible for the EDR discount, MWW's wholesale users would be responsible for documenting (through EDR customer meter readings) the amount of usage subject to discount. Payments due to MWW would be reduced by the discount amount.

Q. Would this deduction procedure be an unreasonable administrative burden?

A. No. It is a practice very similar to that used in wastewater utilities when a significant share of their customers' water use does not result in contributed wastewater flows. Deduct meters and entirely similar billing practices are commonly employed by wastewater utilities for thermal storage systems or for customers whose products are water based (e.g., beverage bottlers).

Q. What about the job creation requirements discussed in Carrie Lewis' and Andrew Behm's testimony?

Carrie Lewis has proposed a job creation requirement confined to the City of Milwaukee. In response, Mr. Behm curiously asserted "*If the Commission agrees with Ms. Lewis, a separate wholesale EDR would not be appropriate because additional wholesale water consumption would not directly create new jobs in Milwaukee*." (SD12.25, Lines 14-16). This is fundamentally inconsistent with the concepts Mr. Behm appropriately endorsed in the immediately preceding paragraph of his own testimony. If a job creation requirement makes sense, it makes sense across the region - the entirety of which faces economic development challenges (and is burdened by MWW's excess capacity). MWW's request for a job creation for Milwaukee should not be a basis for denying the extension of an EDR for users within wholesale customer service areas. A job creation requirement could easily be expanded to cover the entire region.

Q. What is your position with regard to the other qualification issues discussed in Carrie Lewis' and Andrew Behm's testimony?

A. Whatever qualification requirements are ultimately established, the administration of these requirements will require collaboration such that candidate EDR users and service providers face similar logistics across the region. As such, a measure of simplicity is preferred in the establishment of the EDR.

Q. What comments do you have regarding the supplemental testimony offered by David Prochaska?

A. Mr. Prochaska's testimony offers a straightforward reporting of the process undertaken to update the proposed rate design given MWW's rate application revisions and PSC staff changes to its COSS. However, a point that he makes in his supplemental testimony, which reiterates his earlier testimony, underscores a fundamental concern with MWW's rate increase request and the PSC's effective affirmation thereof. In particular, Mr. Prochaska notes that: "*In moving toward the cost of service in recommended rates, I have done some tempering of the rate increases to customer classes within some of the classifications of service that, according to the cost of service study, should receive the largest percentage increases."* (D12.31, Lines 4-7) As such, he is highlighting a fundamental principle of ratemaking that is responsive to the public interest – specifically, that the public interest is served by tempered, gradual rate adjustments. Yet, the PSC has failed to require such tempering in considering MWW's revenue requirement request. Rather than move gradually from a 3.30 percent rate of return toward a higher return amount (though not the 5.18% requested by MWW), the PSC affirms MWWs request – despite the fact that this will result in excessively large single year rate adjustments for all customers. If the PSC is to allow a higher rate of return for MWW, authorizing such a dramatic change all at once does not serve the public interest.

Q. Would not tempered rate increases result in inadequate revenues to support MWW's operations, maintenance and capital reinvestment needs?

A. No. Perhaps what is most disconcerting about MWW's rate increase request and PSC's affirmation of MWW's requested revenue requirements with minor adjustments is that it fails to recognize that such dramatic rate increases are simply not needed. As Ms. Hubert notes, "*MWW has the discretion to finance the investment with additional debt or capital contribution from the city of Milwaukee*." (SD12.9, Lines 22-23) MWW's current rates or a much more modest rate increase would cover needed operations and maintenance expenses, and its exceptionally limited debt service requirements. MWW has more than adequate capacity to finance capital through debt. And, as a publicly owned utility, it is under no obligation to generate sufficient returns to uphold shareholder value. MWW is a public utility with a disproportionately high level of equity in its capital structure now. It does not serve the public interest to impose dramatic rate increases to further build MWW's equity position. MWW's rate adjustments should be aligned with a strategic financial plan that supports efficient operation and maintenance and corrects current patterns of inadequate reinvestment in the system. All this may be accomplished with limited rate increases and a more balanced approach to capital financing. While, as Ms. Hubert notes, "[*t]he Commission does not have jurisdiction on the issuance of municipal utility securities.*" (SD12.8, Lines 3-4), it does have jurisdiction over approval of rate increases which would not need to be nearly so high if MWW would adopt a more balanced approach to capital financing.

Q. Can you summarize your testimony with regard to the wholesale customers position on the COSS?

A. Yes. My testimony focuses primarily on the determination of revenue requirements and in particular rate of return, as well as the extension of the proposed Economic Development Rate to wholesale service areas. In short, myopic adherence to the standards and practices that the PSC typically applies in utility rate cases results in an egregious outcome when a utility applicant, like MWW, is highly atypical. MWW should not be placed in a position whereby it has effective discretionary use of in excess of 20 percent of revenue requirements because of methods for determining rate of return that are blind to capital structure and PILOT provisions. American Water Works Association guidance suggests use of an alternative rate of return; Wisconsin statutes prescribe use of monies within the MWW system at levels that MWW has not employed for decades.

Q. Are the opinions you express in this testimony to a reasonable degree of professional certainty?

A. Yes.

Q. Does this conclude your pre-filed testimony?

A. Yes.